

# The Rise of the Private Markets Poses Risks for Retail Investors and Capital Formation



By BENJAMIN SCHIFFRIN

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## Overview

The “explosive growth of private markets” is perhaps the “single most significant development in securities markets in the new millennium,” observed former SEC Acting Chair and Commissioner Allison Herren Lee.<sup>1</sup> As discussed below, that’s because much of the growth of the private markets comes at the expense of the public markets, which are deep, liquid and the envy of the world, providing capital to American and global businesses as well as investment opportunities for investors worldwide.

Private markets refer to the markets for corporate securities that are not sold to the general public but rather are normally available only to institutions and wealthy individuals.<sup>2</sup> That’s because those markets are not liquid and have fewer disclosure requirements and investor protections. That’s why private markets are sometimes referred to as “dark markets.” In contrast, public markets refer to the stock markets where shareholders can freely buy and sell shares of companies that list their shares on exchanges and offer their shares to anyone with the funds to buy them.<sup>3</sup> Because these markets have retail as well as institutional investors, the disclosure requirements are higher and there are more investor protections.

In the latter half of the 20th century, the public markets dominated financial activity in the United States as successful companies sought to undergo initial public offerings (“IPOs”) and issue shares of stock to the public.<sup>4</sup> In the last 25 years, however, the United States has experienced a significant decline in the number of IPOs, the number of firms listed on stock exchanges, and the aggregate contribution of listed firms to economic activity.<sup>5</sup> Over the same time period, capital raised privately in the United States has increased to the point that the aggregate amount of capital raised in the private markets has surpassed the aggregate amount of capital raised in the public markets every year since 2017.<sup>6</sup>

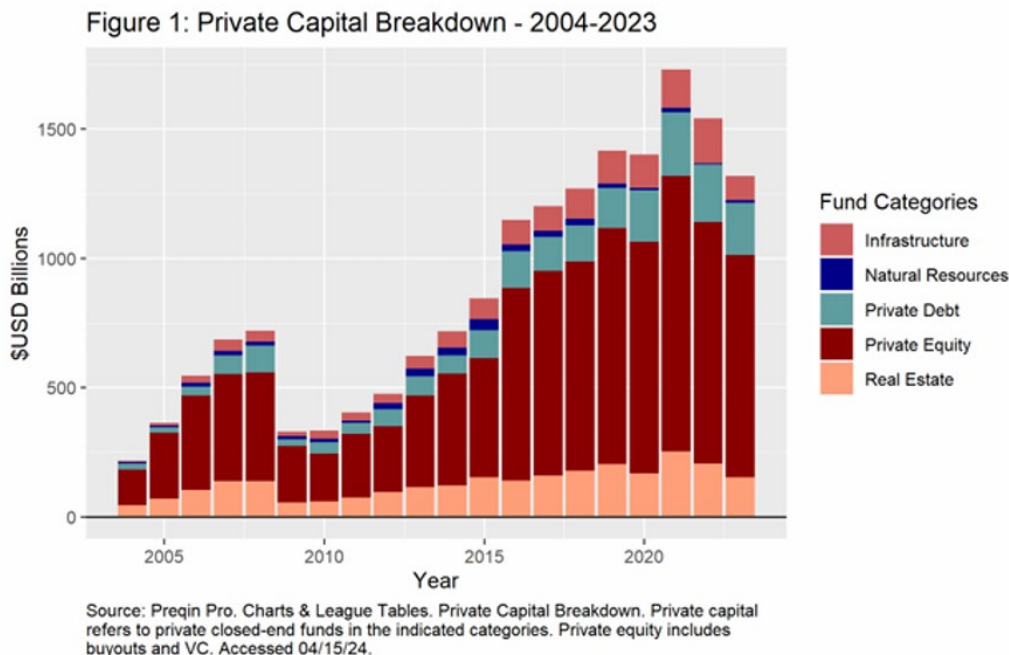
The growth of the private markets has significant ramifications for institutional investors, retail investors, and capital formation, and, therefore, for the entire economy and all Americans. First, pension funds have been increasing their investments in the private markets. But the lack of transparency in the private markets means that these investments have heightened risks, which endangers the retirement savings of America’s teachers, firefighters, and police officers. Second, the financial industry is increasingly trying to induce retail investors to invest in the private markets directly. But the private markets lack the fundamental protections that the federal securities laws provide retail investors in the public markets. Third, empirical research shows that capital is allocated more efficiently in public markets rather than private markets. Since the goal of capital formation, including especially via the markets, is to get capital to its most productive uses, capital raising through the private markets may not lead to productive capital formation or as productive as it would otherwise be if it happened in the light of day in the public markets, which are subject to often intense scrutiny.

This report highlights the rise of the private markets and its consequences. Foremost among them are that the increasing use of the private markets to raise capital poses risks for investors and the economy. However, revitalizing the public markets will both protect investors and facilitate capital formation.

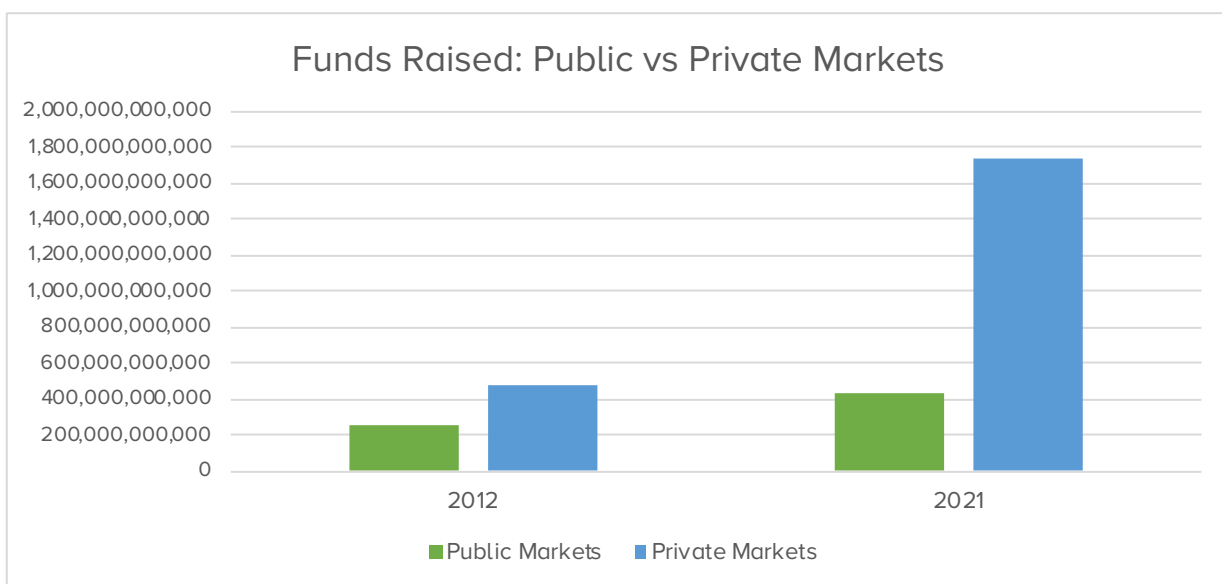
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## The Rise of the Private Markets

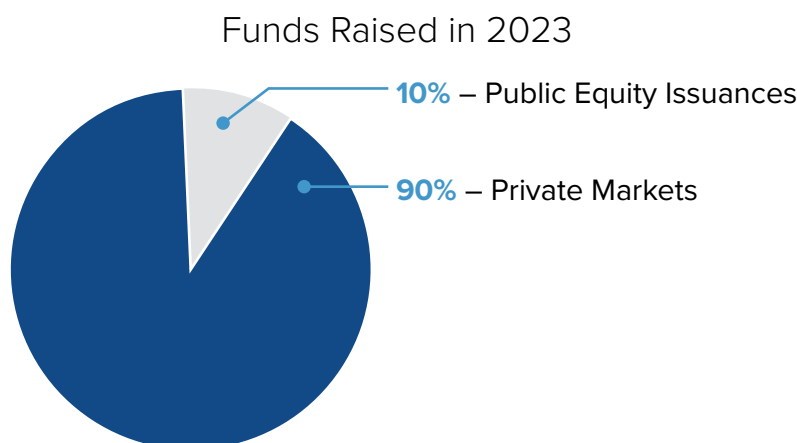
The last twenty years have seen explosive growth in the private markets. In 2004, the private markets raised \$216 billion in total committed funds. The private markets raised \$1.73 trillion in 2021—about eight times more than in 2004—and \$1.32 trillion in 2023.<sup>7</sup>



A comparison to capital raising in the public markets in the last decade or so is especially stark. From 2012 to 2021, the private markets grew from raising \$475.5 billion to raising \$1.73 trillion. Public equity issuances over that same time period went from \$264.6 billion in 2012 to \$434.7 billion in 2021. So the private markets grew almost twice as fast as the public markets in terms of capital raising in that ten-year period.<sup>8</sup>



The amount of money raised in the private markets now dwarfs that of the public markets. In 2023, private markets raised \$1.32 trillion in committed funds. Public equity issuances resulted in only \$139.1 billion raised in 2023—or about 10% of the private markets.<sup>9</sup>



Overall, private funds have approximately tripled in size in the last decade to \$26 trillion.<sup>10</sup>

## The Regulatory Regime

“Congress enacted the original securities laws to protect investors from the types of market abuses that precipitated the stock market crash of 1929 and the ten-year Great Depression that followed.”<sup>11</sup> The crash, in Congress’s view, stemmed from the lack of information for investors to make sound investment decisions.<sup>12</sup> So the fundamental purpose of our current regulatory regime “is to ensure that the reasonable investor is equipped with sufficient knowledge to make informed investment decisions.”<sup>13</sup> For this reason, an offer or sale of securities must normally be registered, and registered offerings are subject to comprehensive disclosure requirements.<sup>14</sup> The federal securities laws thus protect retail investors through a mandatory disclosure framework for public offerings.<sup>15</sup>

“However, private markets do not offer the same protections and disclosure of information as public markets.”<sup>16</sup> Indeed, whereas public company investing requires full disclosure, private company investing operates on a caveat emptor basis.<sup>17</sup> So there will be more failures in the private markets than the public markets, which reflects the need for more acceptance of risk in the private markets.<sup>18</sup> Thus, our system of securities regulation is designed largely “to protect investors by placing conditions on firms’ access to capital, as well as restrictions on ordinary investors’ ability to invest in non-public companies.”<sup>19</sup> Those restrictions exist because private companies are generally exempt from regulation.<sup>20</sup>

As a result, private offerings were originally restricted to institutional investors and high net worth individuals who had the wherewithal to evaluate investments on their own and could bear the risk of significant losses. But over the last several decades, Congress and the SEC have steadily expanded the exemptions that permit private offerings free from the registration and disclosure requirements that govern public offerings.<sup>21</sup> It is these expanded exemptions that have allowed capital raising in the private markets to surpass capital raising in the public markets.<sup>22</sup> So we now have two parallel markets.<sup>23</sup> One is a shrinking public market that is transparent and well-regulated.<sup>24</sup> The other is an expanding private market that is dark and mostly unregulated.<sup>25</sup>

To this point, the exemptions for private offerings have mostly allowed private firms and private funds to raise more money from institutional investors and high net worth individuals than in the past. But, as discussed below, this has consequences for retail investors given that the institutions investing in the private markets are increasingly pension funds.

Even more troubling, the asset management industry is now seeking to raise money in the private markets from retail investors directly. The asset management industry's efforts in this respect stem from ostensibly laudable goals: remedying a perceived inequality of opportunity for retail investors; and encouraging efficient capital formation.<sup>26</sup> The problem is that increasing investor participation in the private markets is unlikely to either benefit retail investors or make capital formation more efficient.<sup>27</sup>

With respect to opportunities for retail investors, there is substantial reason to believe they would do worse in the private markets than in the public markets.<sup>28</sup> That is because the public markets were designed to create an even playing field for retail investors, but the private markets give every advantage to insiders and institutional investors with more bargaining power, sophistication, and access to information.<sup>29</sup> In other words, although proponents of opening up the private markets say that retail investors should not be excluded from the high returns supposedly offered by private firms' early-stage growth, those returns are generally achieved only "by taking on higher risk and are often driven by the operational and financial sophistication of institutional investors."<sup>30</sup> "For investors who lack financial sophistication and proper advice, the risks of investing in private markets can be 'exponentially higher,' and the expected returns are significantly decreased."<sup>31</sup> So retail investors are unlikely to invest early in the next Google.<sup>32</sup>

With respect to capital formation, firms that cannot attract capital from institutional investors tend to be the smallest firms with the worse prospects.<sup>33</sup> So increasing retail investor participation in the private markets may increase the ability of these very high risk firms to raise capital. But that will not necessarily increase the ability of investors to put their capital to its most productive uses.

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## The Much Higher Risks for Retail Investors

The heightened risk of loss for retail investors in the unregulated private markets is well documented. For example, the SEC's Office of the Investor Advocate has frequently "expressed concern about the heightened risks of investing in the private markets compared to investing in the public markets, particularly for retail investors."<sup>34</sup> These risks include "reduced, incomplete, or unreliable disclosure, illiquidity, and greater risk of fraud and/or investment loss."<sup>35</sup> There are also "legitimate concerns that unicorns and other large private companies are dramatically overvalued."<sup>36</sup> "The lack of disclosure has allowed this problem to escalate."<sup>37</sup> Firms can also charge retail investors more for private market strategies.<sup>38</sup> Expenses at some funds can run as high as 5.94%, with an average of 2.91%.<sup>39</sup> So retail investor access to private funds can come at a high price.

The SEC recently tried to minimize these risks by adopting a rule that would have required private funds to issue quarterly performance and fee reports, perform annual audits, and stop giving some investors preferential treatment.<sup>40</sup> But the Fifth Circuit Court of Appeals vacated the rule in June.<sup>41</sup> As a result, despite these requirements having long been standard in public markets, private market investors will continue to be left in the dark.<sup>42</sup>

This would matter less if private market investors were only institutions and high net worth individuals. But 34 million Americans now have their pensions exposed to the private markets.<sup>43</sup> Indeed, the rise of the private markets in conjunction with an increased willingness of public pension funds to invest in alternative assets is especially problematic.<sup>44</sup> In 2020, public pension plans in the United States represented 35% of all capital in private funds and were the largest investor in the asset class.<sup>45</sup> So "the largest private fund investors" were "public pension plans that invest on behalf of teachers, firefighters,

and other public employees.”<sup>46</sup> This means that “private fund performance affects the financial well-being of everyday Americans.”<sup>47</sup> As a result, the “largest concern” with the rise of largely unregulated private markets “stems from the increase in public capital, particularly from pension funds and other retirement vessels, flowing into private markets with few disclosure mechanisms in place to protect it.”<sup>48</sup>

The increasing exposure of pension funds to private markets poses another risk for retail investors. Many institutional investors are now fully allocated to the private markets.<sup>49</sup> As a result, the asset management industry is now trying to find ways to sell private market assets to retail investors directly.<sup>50</sup> It is not surprising that, since the traditional sources of funding in the private markets are drying up, the private markets now want retail investors. But should retail investors want the private markets?

As indicated above, there is cause for concern. The problem with providing retail investors with greater access to the private markets is that the private markets “are plagued with asymmetric information, illiquidity, and long holding periods.”<sup>51</sup> Retail investors are used to ample, regular and uniform disclosure about companies they might invest in as well as easy access to their money.<sup>52</sup> Indeed, retail investors “are more likely to ‘have liquidity needs that institutional investors typically do not.’”<sup>53</sup> But the private markets involve assets that are inherently illiquid and hard to value.<sup>54</sup> And retail investors would be investing in the private markets at a time of unprecedented illiquidity for the industry.<sup>55</sup> An additional risk is that many of the offerings are untested in volatile markets.<sup>56</sup>

All this means that any attempt to provide more investors, including retail and elderly investors, with supposedly lucrative opportunities in the private markets must account for the fact that these opportunities come with much higher risk and much less transparency about the nature of that risk.<sup>57</sup> Indeed, given “the risks associated with investing in private firms, it is only logical that there should be additional investor protections, not less.”<sup>58</sup> Thus, the SEC’s recent desire to inject more transparency and protection seems entirely understandable and laudable and the court’s elimination of its rule all the more lamentable.<sup>59</sup>


## Private credit ETFs

One proposed method of increasing retail investors’ exposure to the private markets bears special attention. The asset management industry is trying to launch private credit exchange-traded funds (ETFs).<sup>60</sup> ETFs are usually low-cost portfolios that trade like stocks and typically track an index.<sup>61</sup> So they normally offer retail investors a way to diversify their risk while investing in the public markets.<sup>62</sup> But private credit is a part of the private markets that involves lending by non-bank institutions.<sup>63</sup> Private credit funds raise capital from investors as do private equity funds, but they make loans rather than buy equity.<sup>64</sup> The potential for ETFs to expose retail investors to private credit carries enormous risk.

This is because private credit funds typically invest in illiquid debt investments.<sup>65</sup> As a result, the loans that private credit funds make are difficult to value in the best of times.<sup>66</sup> And such products can react unpredictably in market downturns.<sup>67</sup> So there is a mismatch between the liquidity profile of private credit as an underlying asset and the expectation of retail investors that ETFs are normally highly liquid.<sup>68</sup> The concern is that retail investors may not understand the investment risks in the illiquid asset class that is private credit.<sup>69</sup>

The proponents of these ETFs say that making private debt more accessible to a wider swath of investors would “democratize access to private asset exposures.”<sup>70</sup> But we’ve seen what happens when exposing retail investors to riskier assets is packaged in marketing terms designed to disarm investors like “democratizing finance.” For example, Robinhood claims its mission is to democratize finance for all.<sup>71</sup> Yet Robinhood has induced “users with little to no investment experience” to “trade the riskiest products” and “trade more frequently to their detriment.”<sup>72</sup> Its “entire business model





depends on the ‘poor’—ordinary investors with surplus capital—making capital allocation decisions without regard to information relevant to a security’s payoff, so that the ‘rich’ can benefit.”<sup>73</sup> As a result, it “generates profit to principal trading firms, rather than investment in economic coordination and social provisioning that will grow the real economy.”<sup>74</sup> This is why “democratizing finance” has been described as “open[ing] up the casino to as many people as possible, while masking it in the language of universal stock ownership.”<sup>75</sup> Skepticism is therefore warranted that supposedly democratizing access to the private markets will actually benefit retail investors.<sup>76</sup>

As a CEO of a profit maximizing too-big-to-fail, too-big-to-manage, and too-big-to-jail Wall Street bank, Jamie Dimon and Better Markets don’t often agree. But occasionally we do,<sup>77</sup> and this is another example. Dimon recently warned that private credit markets could cause turmoil as retail investors are increasingly exposed to the space and encounter private credit assets that might be illiquid, improperly marked, or not stress-tested.<sup>78</sup> Dimon said “there could be hell to pay” as retail investors get access to private credit assets that tend to be less liquid than traditional financial assets.<sup>79</sup> Perhaps most troubling, Dimon noted that the opaqueness of the market reminded him “a little bit of mortgages”<sup>80</sup>—and we know how that turned out.<sup>81</sup>

Indeed, Professor Lenore Palladino at the University of Massachusetts at Amherst has warned that beyond the risks to retail investors private credit poses systemic risks.

Private credit funds pose a unique set of potential systemic risks to the broader financial system because of their interrelationship with the regulated banking sector, the opacity of the terms of their loans, the illiquid nature of the loans and potential maturity mismatches with the needs of limited partners to withdraw funds, and the fact that this growing market has never been through a downturn in the business cycle.<sup>82</sup>


So, according to Palladino, private credit involves “loans made to companies using financial assets that ultimately come from households, in which the loans are risky and opaque, and the terms bespoke, and in which risk is passed along through securitization so that it’s unclear where it lives.”<sup>83</sup> Palladino concludes starkly that if you replace “financial” with “mortgage” “we have the basic setup of the last financial crisis.”<sup>84</sup>

For these reasons, the International Monetary Fund recently published a report “urging ‘a more intrusive supervisory and regulatory approach to private credit funds,’ to address growing risks.”<sup>85</sup> The proliferation of private credit ETFs will only make these risks much greater.

## The Capital Formation Conundrum

As just discussed, the rise of the private markets poses risks beyond those to retail investors. The changes to the securities laws implemented by Congress and the SEC that have contributed to the growth of the private markets were undertaken ostensibly to facilitate capital formation.<sup>86</sup> And there is no question that investors are increasingly allocating capital outside of public equity markets and in the private markets.<sup>87</sup> But the problem with saying we should give retail investors greater access to the private markets to facilitate capital formation is that it equates capital formation with capital raising.<sup>88</sup> The ability to raise funds is not the same thing as capital formation and should not be treated like it is.<sup>89</sup> Real capital formation is about directing capital toward the most productive investment opportunities,<sup>90</sup> ideally in the most efficient way possible.

The 2008 financial crisis exemplifies the difference between capital raising and capital formation. In that crisis, “the savings of hard-working Americans went into investments that would up being worth little, if anything.”<sup>91</sup> Many of these financial instruments were supposed to facilitate capital formation but ended up “damaging financial stability and thus impairing economic growth.”<sup>92</sup> That is because they induced



investors to invest in them but in situations “where no disclosure was required.”<sup>93</sup> So the financial crisis shows that “the singular act of raising capital does not necessarily result in capital formation.”<sup>94</sup> Indeed, the capital raising that occurred before the 2008 crash actually resulted in historic levels of capital destruction.<sup>95</sup>

Instead, real capital formation is about ensuring that investors have the information they need to make decisions so the companies with the best ideas receive the financing they need to make those ideas a reality.<sup>96</sup> The best way to do that is through disclosure requirements that help investors determine where to invest their capital.<sup>97</sup> These disclosure requirements exist in the public markets but are entirely missing from the private markets.

The presence of disclosure requirements in the public markets and their absence in the private markets suggests that capital should be allocated more efficiently in the public markets, and the evidence supports this supposition. A recent study shows that “public markets allocate capital considerably more efficiently than private markets.”<sup>98</sup> According to the study, a dollar of capital allocated in public markets generates \$0.35 more in annual revenue over the next three years than a dollar allocated to a comparable firm via a private market deal.<sup>99</sup> The study also finds that the explanation for this result is that

better informational efficiency and governance mechanisms in public markets increase allocation efficiency by helping investors and managers identify and direct capital to more productive projects.<sup>100</sup>

This study supports the view that facilitating capital formation is best accomplished by strengthening public markets rather than expanding private markets.

Nonetheless, proponents of expanding private offering exemptions and increasing retail investors’ access to the private markets contend that doing so will facilitate capital formation. Doing so would certainly allow private firms and private funds to raise money more easily, but the goal of capital formation is not simply the ability to raise funds.<sup>101</sup> Instead, the goal of real capital formation is to get capital to its most productive use.<sup>102</sup> Unconstrained capital raising can be in direct conflict with this goal.<sup>103</sup> For example, the “rise of private capital has led to very significant losses at firms such as Theranos,” and “many unicorns do not turn a profit.”<sup>104</sup> So the growth of the private markets has allowed firms to raise funds more easily, but has not necessarily led to real capital formation.

This is because “regulation and mandatory disclosure are essential to strong capital formation and real economic growth.”<sup>105</sup> Both are absent from the private markets. As a result, instead of pushing to further expand the private markets, we should heed the empirical evidence that emphasizes “the importance of stock markets in efficiently allocating capital and promoting economic growth,”<sup>106</sup> and bolster those markets.

This means that the consequences of raising capital through the private rather than public markets extend beyond the risks to retail investors. As more companies take advantage of the changes to the securities laws that allow private companies to stay private longer or even induce them to go private, the “resulting shrinkage of public equity markets may be leading to increased inefficiencies in our public market valuations to go hand in hand with private market inefficiencies.”<sup>107</sup> And the ability to stay private

undermine[s] the regulatory capacity of securities law: firms can avoid important disclosure and governance mandates by delaying or never going public, by going private, or by selling off ‘bad’ assets to a private company.<sup>108</sup>



Since public company regulation “fulfill[s] important roles in ensuring corporate transparency and accountability . . . the breakdown of the public-private divide is a problem not just for capital market participants, but for society as a whole.”<sup>109</sup>

## Conclusion

Five years ago, Duke Law Professor Elisabeth de Fontenay gave Congressional testimony on whether increasing retail investor presence in the private markets would be good for investors or good for capital allocation.<sup>110</sup> Her answer is just as important today:

The fact that we have finally achieved some success in steering retail investors’ retirement money to low-cost index funds should rightly be considered one of the crowning achievements of the last decade of investor protection. That we would choose this moment to encourage retail investors to pursue undiversified, high-risk investments with poor return prospects seems puzzling, to say the least.<sup>111</sup>

We’ve recently highlighted the benefits of index funds for retail investors; in that report, we noted that the industry rarely promotes index funds because it makes more money selling active funds.<sup>112</sup> As discussed above, the industry may also make more money selling alternative private funds, but that does not mean we should increase retail investors’ access to those funds so that they can be induced to pay more for less.<sup>113</sup>


The problem isn’t the desire to encourage retail investor participation in the markets. Finance can and should be genuinely democratized.<sup>114</sup> Nor is the problem the desire to facilitate capital formation. There is no question that the private markets have a role to play in capital formation.<sup>115</sup> But the real problem is that the public markets are contracting and are being cannibalized by the rise of the private markets. And the solution isn’t to expose retail investors to riskier assets in less liquid markets without adequate disclosures. In other words, if Congress and the SEC are concerned about shrinking or inadequate investment opportunities for retail investors and facilitating capital formation, “the solution lies not in throwing retail investors to the wolves in the private markets.”<sup>116</sup> Instead, the solution is to increase participation in the public markets.

One way to do this would be to ensure “a healthy pipeline of companies going and remaining public.”<sup>117</sup> A constant criticism of the public markets is that they are too costly to access and that there is too much regulation once a company goes public.<sup>118</sup> Policymakers should consider ways to make access to the public markets easier. But there are good reasons for the regulations imposed on public companies.

Part of the cost of gaining access to the public markets and the billions of dollars that can be accessed there is disclosing all the material financial and business aspects of your company on an ongoing basis. Companies are legally required to tell the investing public “the good the bad and the ugly” regarding their company.<sup>119</sup>

So the benefits of public company regulation, and what is lost when companies are able to avoid going public, is that “the disclosure regime requires disclosing to the public all the bad things that can happen to the issuer.”<sup>120</sup> This is what protects investors.

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Ensuring a healthy pipeline of companies going and remaining public would thus require reversing the ever-expanding exemptions from the registration requirements of the securities laws.<sup>121</sup> Allowing the increasing use of these exemptions draws issuers and capital away from the public markets and thereby “reduce[s] the liquidity, price discovery, and information quality that have made the U.S. capital markets the envy of the world for over 80 years.”<sup>122</sup> So rather than blindly continuing to expand exemptions from securities registration or listening to self-interested parties making self-serving statements about how that would be great for retail investors without mentioning their economic conflicts of interest, we should pause to ask whether doing so undermines the public markets that have served retail and institutional investors so well and that are so vital for our economy and standard of living.<sup>123</sup>

Indeed, there is no question that the public markets “generate large social benefits.”<sup>124</sup>

In particular, public stock markets (1) generate information and promote the efficient allocation of capital; (2) lower the cost of capital and encourage the pooling of savings; (3) facilitate the efficient amelioration of risk via easy diversification and liquidity, and (4) allow small savers to participate in the wealth generation of big business. . . . These wide-ranging benefits are difficult to qualify, but they are manifestly large.<sup>125</sup>

Essentially, “it is the ability to tap the public equity markets that allows companies to grow and prosper.”<sup>126</sup> And so a “large shift away from public markets imperils [their] benefits.”<sup>127</sup>

The fact that the public markets have served retail investors and the country so well is precisely why increasing retail investor access to those markets is essential. We should democratize finance by ensuring that more investors are able to participate in the stock market fairly,<sup>128</sup> because investing in the stock market has proven to be one of the best ways to build wealth.<sup>129</sup> We shouldn’t expose investors who have done well in the public markets to markets with which they are unfamiliar, and which do not have the basic protections that the foundational securities laws were designed to provide for them. Instead, more people, including young, less experienced, and less wealthy investors should be able to participate and invest in the stock market and accumulate wealth.<sup>130</sup> That would be good not only for them but also for capital formation, price discovery, the economy, and the country.<sup>131</sup>

## Endnotes

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- 4 *Id.*
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- 9 *Id.*
- 10 *Id.* at 1; see also William W. Clayton, *High-End Securities Regulation: Reflections on the SEC's 2022-23 Private Funds Rulemaking*, 14 Harv. Bus. L. Rev. 71, 76 n.21 (2024) (“Remarkably, the value of private market assets has grown by fourteen times since 2000.”).
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- 23 Kelleher and Hall, *supra* note 21, at 2.

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25 *Id.*

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35 *Id.*

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